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No. 99-409

IN THE

# Supreme Court of the United States

HARTFORD UNDERWRITERS INSURANCE COMPANY,

*Petitioner,*

*v.*

UNION PLANTERS BANK, N.A.,

*Respondent.*

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

## REPLY BRIEF

WENDI ALPER-PRESSMAN
SUSMAN, SCHERMER,
RIMMEL & SHIFRIN LLC
7711 Carondelet Ave.
St. Louis, Missouri 63105
(314) 725-7300

G. ERIC BRUNSTAD, JR.*
PATRICK J. TROSTLE
RENEE M. DAILEY
MARK W. DEVENO
HELDER P. PEREIRA
BINGHAM DANA LLP
One State Street
Hartford, Connecticut 06103
(860) 240-2700

*Attorneys for Petitioner*

* *Counsel of Record*

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## I. THIS CASE INVOLVES THE PROPER DISTRIBUTION OF PROPERTY OF THE DEBTOR'S BANKRUPTCY ESTATE, AND THE DEBTOR'S ESTATE SHOULD BE DISTRIBUTED IN ACCORDANCE WITH THE PRIORITIES SET BY THE GOVERNING STATUTORY SCHEME.

Magna disputes that Hartford may obtain relief under section 506(c) on the theory that Hartford seeks to pursue a private cause of action that Congress has not authorized against Magna and its property. Specifically, Magna frames the issue as "whether Congress intended for Section 506(c) to provide third party claimants such as Hartford with a right of recovery against secured creditors and/or their collateral," and defines the present controversy as "a demand for monetary relief" arising "between private parties." (Magna's Brief at 46-47, 49). But this matter does not involve an implied private controversy between a claimant and a secured party over the secured party's property. On the contrary, it involves the proper distribution of encumbered property belonging to a bankruptcy estate, and likewise concerns persons who are already parties in interest in the relevant bankruptcy proceedings, and are already subject to the requirements of the governing Bankruptcy Code regarding the treatment of their respective claims.

As Justice Frankfurter explained in his concurrence in *Vanston Bondholders Protective Committee v. Green*, 329 U.S. 156, 170 (1946), "[p]utting the wrong questions is not likely to beget right answers even in law." Moreover, invoking "the classic admonition to begin at the beginning," he observed succinctly that "[t]he business of bankruptcy administration is to determine how existing debts should be satisfied out of the bankrupt's estate so as to deal fairly with the various creditors." *Id.* at 169. In this instance, Magna mischaracterizes the nature of the proceedings in an effort to obscure the relevant analysis. In truth, this matter involves nothing more than a priority dispute over the distribution of property of the estate as to which section 506(c) directs that Magna ought not to prevail.

As explained in Hartford's initial brief, bankruptcy proceedings are fundamentally *in rem* in nature, and in the context of an *in rem* insolvency proceeding, parties such as Hartford have a recognized stake in ensuring the enforcement of the governing statutory scheme because they hold a tangible financial interest, and because "everyone with a claim to the *res* has a right to be heard before the *res* is disposed of since that disposition will extinguish all such claims." *In re James Wilson Assocs.*, 965 F.2d 160, 169 (7th Cir. 1992); (*see* Hartford's Brief at 32-34). In some instances, of course, the trustee is authorized to ensure the fulfillment of the relevant statutory scheme. In this instance, however, Magna seeks to exploit the trustee's inability and lack of incentive to enforce compliance with section 506(c) as a basis to secure for itself the very windfall that the section seeks to prevent. In other words, Magna champions a result demonstrably at odds with Congress's intent in enacting section 506(c). (*See* Hartford's Brief at 11-14) (discussing the purpose of section 506(c)). As this Court has indicated, it will not construe the provisions of the Bankruptcy Code to achieve such a result. *See United States v. Ron Pair Enters., Inc.*, 489 U.S. 235, 242 (1989) (observing that a statute is not to be construed in a manner that "will produce a result demonstrably at odds with the intention of its drafters"). Similarly, as this Court stated unanimously in rejecting a construction of the Bankruptcy Code in the setoff context that would have eviscerated the relevant statutory purpose, "it is an elementary rule of construction that 'the act cannot be held to destroy itself.' " *Citizens Bank of Maryland v. Strumpf*, 516 U.S. 16, 20 (1995) (quoting *Texas & Pac. Ry. Co. v. Abiline Cotton Oil Co.*, 204 U.S. 426, 446 (1907)). In this case, the destruction of section 506(c) is precisely what Magna has in mind, but Magna ought not to prevail.

To demonstrate in sharper detail why Magna ought not to prevail, it is helpful to illustrate the two ways in which a claim under section 506(c) may arise. Doing so reveals not only the errors in Magna's argument, but also more clearly why it is that



claimants such as Hartford are entitled to pursue recovery under section 506(c).

To begin with, suppose that a bankruptcy estate owns a parcel of land encumbered by a lien in favor of a secured party. Suppose further that the land is contaminated with toxic waste that reduces the value of the land. The trustee may contract with a third party to have the waste removed, and may then pay the cost from unencumbered funds of the estate. Later on, the trustee may also sell the land. *See* 11 U.S.C. § 363. To the extent the trustee's clean-up activities have increased the value of the land (thereby bestowing a direct benefit on the secured party by increasing the value of its collateral), the trustee may commence a proceeding to recover the clean-up costs from the proceeds of the sale under section 506(c) to replenish the estate for the amount the trustee has paid.

Suppose, however, that after the contractor completes the remediation, the trustee informs him or her that there are no unencumbered funds in the estate to pay the contractor's bill. Suppose further that the secured party refuses to consent to the use of its collateral (i.e., the land or its proceeds) to pay the bill, and the trustee also has no funds to litigate the issue with the secured party. Under Magna's theory, the contractor is simply out of luck, and the bank walks away with the full proceeds of the sale enhanced by the contractor's clean-up services–a result demonstrably at odds with the purpose of section 506(c), which is precisely to prevent the secured party from receiving such a windfall. (*See* Hartford's Brief at 12-13).

Similarly, suppose that the party performing the remediation is a state or federal agency. Under Magna's approach, the agency would have no right to recover its remediation costs from a secured party's collateral if the trustee lacks the ability or incentive to pursue payment of the agency's claim on the agency's behalf. Thus, under Magna's theory, those cases holding to the contrary are simply incorrect, and should be overruled. *See Guterl Special Steel Corp. v. Economic Dev. Admin. (In re Guterl Special Steel Corp.)*, 198 B.R. 128, 136-

37 (Bankr. W.D. Pa. 1996) (EPA entitled under section 506(c) to recover its cleanup costs from encumbered property before payment of secured claims); *In re T.P. Long Chem., Inc.*, 45 B.R. 278, 287 (Bankr. N.D. Ohio 1985) (EPA permitted under section 506(c) to seek recovery of its cleanup expenses from secured creditor's funds to same extent as trustee). But Magna offers no explanation why governmental agencies (and therefore the public) should subsidize the recoveries of secured creditors in bankruptcy proceedings.

As the foregoing illustrates, when a trustee pays an administrative claim from unencumbered funds of a bankruptcy estate, the claimant receives payment of its claim, and the trustee may then recover the amount paid from the secured creditor's collateral to the extent of the benefit to the secured party. *See* 11 U.S.C. § 506(c). On the other hand, in cases such as this one in which the trustee has no ability to pay the claim, and no ability or incentive to litigate with the secured party, two outcomes are possible: (i) the secured party may enjoy the benefit of a windfall by obtaining for free the value of the services provided by the administrative claimant; or (ii) the administrative claimant may enforce the priority of its claim under section 506(c). For over a century, the rule has been that the unpaid administrative claimant is entitled to pursue recovery of its claim on its own account. *See Louisville, Evansville & St. Louis R.R. v. Wilson*, 138 U.S. 501, 506 (1891); (Hartford's Brief at 13-14, 21-26); *see also Burnham v. Bowen*, 111 U.S. 776 (1884); John W. Smith, *The Law of Receiverships* 574-75 (1897). Because this rule is necessary to vindicate the purpose of section 506(c) in cases of this kind, the Court should adhere to its prior precedent and conclude that Hartford is entitled to pursue its claim under the statute in this proceeding.[1]

1. Moreover, because the rule is necessary to vindicate the purpose of section 506(c), it is likewise enforceable under 11 U.S.C. § 105. Section 105 provides in relevant part: "The court may issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of this title." 11 U.S.C. § 105(a). Although section 105 is (Cont'd)



Magna argues in opposition that it should be able to obtain its windfall on the theory that parties dealing with bankrupt debtors should either take steps to ensure payment (e.g., by taking a lien, or insisting on C.O.D.), or proceed entirely at their own peril. (*See* Magna's Brief at 35). But apart from the impact that this would have on the estate's ability to obtain credit, and likewise apart from the fact that the very purpose of section 506(c) is to provide a source of payment for "the reasonable, necessary costs and expenses of preserving, or disposing of" property encumbered by a lien, Magna's theory is otherwise unworkable. Bankruptcy estates frequently incur debts to creditors who have no choice but to deal with the debtor. For example, debtors that continue to operate their businesses in bankruptcy frequently incur tax obligations, and may likewise incur environmental liabilities at their facilities. In *United States, Internal Revenue Service v. Boatmen's First National Bank*, 5 F.3d 1157 (8th Cir. 1993), the Court of Appeals recognized the right of the United States to recover under section 506(c) certain administrative taxes incurred during the course of the debtor's failed attempt to reorganize. Under Magna's approach, the United States would have no authority to enforce the requirements of section 506(c).[2] But, again, Magna supplies no reason why involuntary administrative claimants (such as the United States) should incur losses for the benefit of secured parties in the bankruptcy setting.

In this case, Hartford is also an involuntary creditor. Because the Debtor was not creditworthy, the Debtor obtained its workers' compensation insurance from Hartford through an assigned risk pool arrangement. Having tendered its application for insurance, together with a portion of the premium, Hartford

(Cont'd)
not available to prescribe relief in conflict with other provisions of the Bankruptcy Code, it is available to ensure compliance with the Code's requirements. Because that is all that Hartford seeks, section 105 provides further support for Hartford's right of recovery in this case.

2. The court below agreed, and expressly overturned *Boatmen's* in its *en banc* decision. (*See* App. 300a, 308a).

was obliged to accept the Debtor as an insured as a condition of the privilege of writing insurance in the Debtor's state of operations. It is undisputed that Hartford's provision of workers' compensation insurance allowed the Debtor to continue to operate, thereby enabling the Debtor to sell certain of its business operations as going concerns, rather than on the auction block. (*See* App. 216a-217a). It is also undisputed that this enabled the Debtor to maximize the value of its operations, which provided a benefit to Magna by enhancing the value of its collateral. (*See* App. 217a, 163a). Magna argues that it is simply too bad that the Debtor did not pay for this insurance in full, even though Magna agreed originally that the cost should be paid from its collateral, and the bankruptcy court directed the Debtor to pay Hartford's claim. (*See* App. 145a, 178a; Hartford's Brief at 3-4). But there is no reason why Magna should enjoy the benefits of the reorganization process without provision for the payment from its collateral of the costs of preserving and disposing of its collateral. Indeed, section 506(c) directs that Magna's collateral must bear these expenses, and Hartford is entitled to vindicate the statutory purpose where, as here, its claim has not been paid.

## II. SECTION 506(c) DOES NOT PLAINLY DISPOSE OF THE ISSUE PRESENTED IN THIS CASE.

Magna argues that the language of section 506(c) is "plain and unambiguous" in establishing that only a trustee (or debtor in possession) may enforce the relief that the section recognizes. (*See* Magna's Brief at 10). But section 506(c) does not state that "only" a trustee may enforce its terms, nor does it expressly preclude parties such as Hartford from doing so. (*See* Hartford's Brief at 30) (listing sections from the Bankruptcy Code that delimit persons with certain rights). In truth, Magna's interpretation of section 506(c) does not rest on any "plain" directive in the text, but rather on the *inference* that Congress's use of the term "trustee" was intended to: (i) overrule such cases as *Louisville, Evansville & St. Louis R.R. v. Wilson*, 138 U.S. 501 (1891); (ii) overturn a century of prior practice; and (iii)



condone a windfall to the secured creditor by permitting it to enjoy the benefits of services supplied by others that enhance or preserve the value of its collateral without provision for the payment of these services from the collateral. Apart from the implausibility of Magna's interpretation, the mere fact that Magna's "plain meaning" argument turns on an *inference* is sufficient to demonstrate that the meaning of section 506(c) is far from "plain" on the issue in this case. In truth, the instant controversy requires a more comprehensive analysis, not one that ignores the context, history, logic, structure, and purpose of the relevant law, or the larger statutory scheme of which the provision at issue is but a component part. *Cf. BFP v. Resolution Trust Corp.*, 511 U.S. 531, 546-47 (1994) (finding the term "reasonably equivalent value" used in section 548(a)(2) of the Bankruptcy Code to be ambiguous because it did not answer the critical question at issue, thus necessitating a broader inquiry); *Midlantic Nat'l Bank v. New Jersey Dep't of Envtl. Protection*, 474 U.S. 494, 500-05 (1986) (concluding that section 554 should be interpreted in light of prior practice and applicable state law concerns designed to protect the public health and safety).

Magna argues in opposition that reference to the history of section 506(c), particularly the pre-Code practice preceding its enactment, is immaterial because the language of the section is clear. (*See* Magna's Brief at 40). But as Justices Scalia and Thomas noted in their recent concurrence in *Bank of America National Trust & Savings Ass'n v. 203 North LaSalle Street Partnership*, 119 S. Ct. 1411 (1999), reference to pre-Code practice is appropriate where, as here, the text of the relevant statute does not resolve expressly the issue before the Court. *See id.* at 1425. Illustrating their point, the concurring Justices in *LaSalle* cited to the Court's analysis in *Midlantic*, which involved the question of whether a trustee's ability to abandon contaminated property under section 554 of the Bankruptcy Code included restrictions not specified in the statutory text. *See LaSalle*, 119 S. Ct. at 1425; *Midlantic*, 474 U.S. at 501.

Just as the text of section 554 does not by itself resolve the issue decided in *Midlantic*, the text of section 506(c) likewise does not direct expressly that parties in interest such as Hartford have no ability to enforce compliance with the section's requirements.

Moreover, reference to pre-Code practice is even more compelling in this case than in *Midlantic*. In *Midlantic*, the Court discerned the relevant pre-Code practice from two court of appeals decisions and a bankruptcy court decision. *Midlantic*, 474 U.S. at 500-01. In this case, the relevant pre-Code practice traces its origins directly to decisions by this Court, most prominently *Louisville, Evansville & St. Louis R.R. v. Wilson*, 138 U.S. 501 (1891), and numerous court of appeals decisions under the prior Bankruptcy Acts of 1867 and 1898. (*See* Hartford's Brief at 20-23); *see also Burnham v. Bowen*, 111 U.S. 776 (1884); John W. Smith, *The Law of Receiverships* 574-75 (1897). Magna counters that pre-Code practice on the issues addressed in section 506(c) was equivocal, and therefore unpersuasive. (*See* Magna's Brief at 44). This argument, however, is also without merit. Although it may be true that *some* aspects of the pre-Code practice preceding the enactment of section 506(c) were equivocal (e.g., regarding the precise kinds of costs that could be paid from a secured party's collateral), there was no ambiguity on the question of *who* could petition the court for payment of an administrative claim from property encumbered by a secured party's lien. (*See* Hartford's Brief at 23-24, 25 n.18).

Similarly, Magna and its *amicus* argue that Hartford's cases do not demonstrate an established rule of law. (*See* Magna's Brief at 43; Amicus Brief of Commercial Finance Association at 16 n.9). But as Judge Calabresi has explained, there is no better evidence of the existence of a right than its repeated recognition and vindication by the courts, particularly this Court. *See Aetna Cas. & Sur. Co. v. LTV Steel Co. (In re Chateaugay Corp.)*, 94 F.3d 772, 778 (2d Cir. 1996) ("[T]here is no better proof of the existence of a common law right that its exercise, and acceptance by the courts."). In this instance, the evidence



of the relevant pre-Code practice is both more established and more compelling than the evidence in *Midlantic*. Accordingly, as in *Midlantic*, the relevant pre-Code practice should be followed.

In further opposition, Magna argues that the Court should disregard its own precedents under the prior law, as well as those of the lower courts, because, in enacting the provisions of the Bankruptcy Code, Congress intended a general overhaul. (*See* Magna's Brief at 41). This argument, however, is also misplaced. It is certainly true that, in enacting the provisions of the Code, Congress altered expressly some features of the prior legal landscape. (*See* Hartford's Brief at 18-19 n.12). But as explained in the reports of both the House Judiciary Committee and the Senate Judiciary Committee, Congress intended section 506(c) to "codif[y] the current law," not embrace a wholesale revision. H.R. Rep. No. 95-595, at 357 (1977), *reprinted in* 1978 U.S.C.C.A.N. 5963, 6313; S. Rep. No. 95-989, at 68 (1978), *reprinted in* 1978 U.S.C.C.A.N. 5787, 5854.

Moreover, as in *Midlantic*, there is simply no evidence that Congress intended to change the relevant practice predating the enactment of section 506(c). Significantly, just as the legislative history to section 554 is entirely silent on the issue addressed by the Court in *Midlantic*, the legislative history to section 506(c) is likewise silent on the issue of the ability of an administrative claimant to recover certain costs from property encumbered by a lien. *See* H.R. Rep. No. 95-595, at 377 (1977), *reprinted in* 1978 U.S.C.C.A.N. 5963, 6333 (discussing section 554); S. Rep. No. 95-989, at 92 (1978), *reprinted in* 1978 U.S.C.C.A.N. 5787, 5878 (same); 124 Cong. Rec. 32,401 (1978) (same); 124 Cong. Rec. 34,000 (1978) (same). Magna argues that Congress's silence is tantamount to rejection of the prior practice. But this Court has embraced precisely the opposite approach. In *Midlantic* the Court observed that "[i]n codifying the judicially developed rule of abandonment [codified in section 554], Congress also presumably included the established corollary that a trustee could not exercise his abandonment power in

violation of certain state and federal laws." 474 U.S. at 501. Similarly, in codifying the judicially developed rule of equitable surcharge in section 506(c), Congress also presumptively included the established corollary that an individual claimant could recover its unpaid claim directly. Accordingly, Magna's argument is without merit.

## III. ANY RECOVERY UNDER SECTION 506(c) IN THIS CASE BELONGS TO HARTFORD.

Magna argues next that Hartford cannot pursue payment of its claim under section 506(c) because any recovery under section 506(c) must be distributed through the bankruptcy estate in accordance with the Code's hierarchical distribution scheme, and that only a trustee may pursue claims of this kind on behalf of an estate. (*See* Magna's Brief at 20-23). Of course, what Magna really means is that, any recovery under section 506(c) must revert back to Magna. As explained in Hartford's initial brief, Magna holds a lien on all property of the estate, and is therefore perched at the top of the distributional hierarchy. (*See* Hartford's Brief at 3, 5). But what Magna does not explain is why the value of the priority of one party's claim should be distributed in this context to others whose claims have no similar right of payment. In addition, Magna fails to explain why, in situations in which the trustee actually *pays* an administrative claim, and then seeks reimbursement from a secured party's collateral under section 506(c), the claimant is not required to share its recovery, but in situations in which the trustee does *not* pay the claim, the unpaid administrative claimant must share the priority with others whose claims are not entitled to be paid from the secured party's collateral.

In situations in which a trustee actually pays an administrative claim from unencumbered funds of the estate, the administrative claimant receives payment from funds that would otherwise go to pay other unsecured creditors. Hence, when the trustee seeks recovery under section 506(c) for the amount the trustee has paid to the administrative claimant, the trustee seeks merely to take funds that would otherwise go to



satisfy the secured party's claim and reallocate them to the general fund to reimburse the general fund for sums that the secured party's collateral rightfully should bear. In contrast, in situations in which the trustee does *not* pay an administrative claim from unencumbered funds of the estate, the matter is entirely different because the trustee has not made use of unencumbered funds that would otherwise go to pay unsecured creditors. Accordingly, there is no reason why any recovery that the administrative claimant may obtain under section 506(c) should be shared with other unsecured creditors whose own claims do not represent expenses incurred to preserve or enhance property encumbered by the secured party's lien. *Cf. Burnham v. Bowen*, 111 U.S. at 783 (concluding that secured party's collateral should be used to pay claim of party who supplied goods that preserved value of railroad, but should not be "used to pay the general creditors of the road").

An administrative claimant who provides services to a bankruptcy estate is entitled to the payment of its claim. *See* 11 U.S.C. §§ 503 & 507. If the services provide a benefit to a secured party in the preservation or disposition of its collateral, the claim is to be paid from the secured party's collateral on a priority basis from that collateral. *See* 11 U.S.C. § 506(c). Section 506(c) thus defines a special payment entitlement for a discrete category of administrative claims (i.e., those that provide a benefit to the secured party by preserving or enhancing the value of the relevant collateral). In other words, section 506(c) is a priority provision that defines how certain property of the estate (i.e., property encumbered by a lien) shall be used to pay certain specific administrative claims, including Hartford's claim in this case.

Magna argues in opposition that section 506(c) does not define any special type of priority. But the case law recognizes

the section as a priority provision. *See United States v. FDIC*, 899 F. Supp. 50, 55-56 (D.R.I. 1995) ("The priority for payment of claims is that § 506(c) expenses or operating expenses that benefitted the creditor are paid first out of the proceeds of the sale, before a secured creditor is paid. Then after all § 506(c) expenses and secured claims are satisfied, the priority of remaining claims is established by § 507." (citations omitted)); *In re Ascher*, 146 B.R. 764, 771 (Bankr. N.D. Ill. 1992) ("With a super priority claim under § 506(c), Movants are entitled to payment of this claim ahead of any other claimant including the Trustee, and this claim may be recovered directly from the property." (citation omitted)); *In re Mechanical Maintenance, Inc.*, 128 B.R. 382, 389 (E.D. Pa. 1991) ("[S]ection 506(c) costs of preserving or disposing of collateral have a unique superpriority under the Bankruptcy Code.").

Magna and its *amicus* argue further that section 506(c) cannot be a priority provision because it is not referenced in sections 507(a) or 726(b), which prescribe the priority of certain claims. (*See* Magna's Brief at 26-28; Amicus Brief of Commercial Finance Association at 18-19). But Magna's own priority as a secured party is also not mentioned in sections 507 or 726. Yet it does not follow that Magna's priority therefore does not exist.

As courts have noted, section 507 governs the priority of payment among certain unsecured claims, and makes no reference to secured claims because secured claims are entitled to payment from the assets that they encumber. *See United States v. Victor*, 121 F.3d 1383, 1389 (10th Cir. 1997) ("It is unnecessary to extend that special status [of section 507 priority claims] to secured claims because those claims are entitled to repayment from an alternative source of funds — the value of the property encumbered by a lien."). Surely Magna would balk at the suggestion that *its* priority as a secured party should be shared with general unsecured creditors simply because doing so would further the policy of equality of distribution. Properly understood, the policy of equality of distribution applies only



within classes of claims with the same legal rights. *See In re Smith*, 966 F.2d 1527, 1535 (7th Cir. 1992) (noting the " 'prime bankruptcy policy of equality of distribution among creditors' by ensuring that all creditors of the same class will receive the same pro rata share of the debtor's estate" (quoting H. R. Rep. No. 95-595, at 177-78 (1977), *reprinted in* 1978 U.S.C.C.A.N. 5963, 6137-39)). Because claimants with payment rights arising through application of section 506(c) occupy their own defined class, they need not share their recoveries with others who have no similar rights under the section.

In addition, Magna argues that Hartford cannot pursue its claim in this case because doing so would invert the provisions of section 726(b). (*See* Magna's Brief at 22-23). Section 726(b) provides that, in a chapter 7 case, payment of chapter 7 administrative expenses takes priority over unpaid chapter 11 administrative claims. But reference to this provision does not defeat Hartford's claim. In fact, it bolsters it.

As explained above, Hartford's administrative claim bears an attribute that general administrative claims do not bear: it is entitled to payment from Magna's collateral. Hence, regardless of whether the case is a proceeding in chapter 11 or 7, Hartford's claim is still payable out of Magna's collateral. Because Hartford's claim arose during the course of the Debtor's chapter 11 case, Magna suggests that any recovery on account of Hartford's claim should be used first to pay chapter 7 administrative expenses. Not only is this result not directed by section 726(b), it would also create a perverse incentive to exploit the conversion of a case in a way that would undermine the limitations of section 506(c).

Under Magna's approach, a chapter 7 trustee could incur substantial expenses challenging the lien of a secured creditor following the conversion of the case from a chapter 11 proceeding to a proceeding under chapter 7. Ordinarily, administrative expenses incurred in challenging a secured party's lien are not recoverable under section 506(c) because they do not confer any direct "benefit" on the secured party.

*See General Elec. Credit Corp. v. Levin & Weintraub (In re Flagstaff Foodservice Corp.)*, 739 F.2d 73, 76 (2d Cir. 1984). Nevertheless, so long as there existed an unpaid administrative claim from the chapter 11 proceeding that was entitled to be paid from the secured party's collateral, the chapter 7 trustee could incur significant fees and expenses challenging the secured party's lien, and then obtain payment of his or her fees and expenses as an administrative expense from the secured party's collateral by using the funds recovered on account of the chapter 11 administrative claim to pay them. But there is no reason why a trustee should be entitled to use one party's priority to secure a result at odds with the limitations of the governing statutory scheme. Magna's argument is thus unsound, and the Court should conclude that Hartford is entitled to pursue the priority of its own claim in this proceeding.

## IV. THE BANKRUPTCY CODE ALTERS MAGNA'S RIGHTS IN THIS INSTANCE.

In further opposition to Hartford's claim, Magna's *amicus* argues that Hartford should not be entitled to enforce the provisions of section 506(c) because of the general principle that "liens pass through the bankruptcy case unaffected." (*See* Amicus Brief of Commercial Finance Association at 12). Of course, Magna's *amicus* acknowledges that various provisions of the Bankruptcy Code do, in fact, adjust a secured creditor's lien rights. Specifically, it acknowledges that section 506(c) is an example of such an adjustment. Nevertheless, it argues that section 506(c) must be construed narrowly in order to preserve for the secured party the benefit of the concept that its lien should not be touched. But after reviewing the litany of lien modification provisions that Magna's *amicus* recites, one is left with the accurate impression that the concept that "liens pass through bankruptcy" is more myth than reality under the current Bankruptcy Code. And of all the provisions cited, none is more telling on this point than section 552.

Section 552(a) states the general bankruptcy rule that a secured party's lien will not extend to property that the debtor



acquires after it files for bankruptcy relief. 11 U.S.C. § 552(a). Among other things, this provision invalidates after-acquired property clauses in security agreements with respect to property acquired postpetition. *See In re Soto*, 667 F.2d 235, 237 (1st Cir. 1981). Section 552(b)(1), in turn, states an exception to the broad reach of section 552(a), preserving for the secured party's benefit its lien on the proceeds of its preexisting collateral. 11 U.S.C. § 552(b)(1). *See Philip Morris Capital Corp. v. Bering Trader, Inc. (In re Bering Trader, Inc.)*, 944 F.2d 500, 501 (9th Cir. 1991). But as is relevant here, section 552(b)(1) also provides expressly that the secured party's lien does not extend to proceeds in derogation of section 506(c). 11 U.S.C. § 552(b)(1). Hence, to the extent a secured party's collateral is liquidated during the course of the debtor's bankruptcy case (as happened here), the secured party's lien simply does not attach to the proceeds of the sale to the extent that there remains any unpaid administrative expenses chargeable under section 506(c). Thus, by operation of law, Magna's lien in this case simply does not extend to the proceeds of its collateral to the extent of Hartford's claim. In other words, regardless of whether Magna's lien may "pass through bankruptcy," its lien does not attach to funds available to pay Hartford's claim.

In addition, section 552(b)(1) states a further limitation on the ability of a secured party's lien to extend to proceeds by providing that the lien may attach to proceeds "except to any extent that the court, after notice and a hearing and based on the equities of the case, orders otherwise." 11 U.S.C. § 552(b)(1). As explained in the legislative materials to section 552(b)(2) (the companion to section 552(b)(1) that also contains the identical limitation),

> the "equities of the case" provision . . . is designed, among other things, to prevent windfalls for secured creditors and to give the courts broad discretion to balance the protection of secured creditors, on the one hand, against the strong public policies favoring continuation of jobs, preservation of going concern

values and rehabilitation of distressed debtors, generally.

140 Cong. Rec. H10,768 (daily ed. Oct. 4, 1994). Similarly, the legislative history explains the reference in section 552(b) to section 506(c) as follows: "the reference to section 506(c) permits broad categories of operating expenses — such as the cost of cleaning and repair services, utilities, employee payroll and the like — to be charged against [the secured party's collateral]. . . . These rights, preserved by the list of sections, would not be waivable by the debtor, either pre- or postpetition." *Id.*

Because Magna's lien does not extend to funds properly available to pay Hartford's claim, the argument that "liens pass through bankruptcy" simply has no force in this context. Certainly it is clear from section 552(b)(1) that Magna is not entitled to the relevant funds. Because Hartford's claim remains unpaid, Hartford is entitled to the funds in order to vindicate not only its own interest, but also the policies that section 506(c) promotes, and that the Code as a whole (including section 552(b)) fully supports.

## V. MAGNA IS SUBJECT TO THE BANKRUPTCY CODE'S GOVERNING REGULATIONS, INCLUDING ITS CLAIMS ALLOWANCE RULES, AND HARTFORD MAY ENFORCE THESE RULES TO THE EXTENT OF ITS ECONOMIC INTEREST.

In its initial brief, Hartford pointed out that, pursuant to section 502 of the Bankruptcy Code, any party in interest may object to the allowance and payment of any claim of any creditor, including a secured creditor. (*See* Hartford's Brief at 35). Hartford also observed that a secured creditor's claim should not be allowed and paid from the secured party's collateral in derogation of the requirements of section 506(c) (a position supported entirely by reference to section 552(b)). Because parties in interest may enforce indirectly the requirements of section 506(c) by objecting to the payment of a secured claim to the extent of any unpaid 506(c) expenses, Hartford argued



any party in interest should also be permitted to enforce the requirements of section 506(c) directly in situations in which the trustee has no ability or incentive to enforce the section's terms. (*See id.* at 36-37).

In response, Magna argues that, if Hartford believed that it had a right to object to Magna's claim, then Hartford should have objected to Magna's claim. (*See* Magna's Brief at 30-31). Apart from the fact that objecting to a secured party's claim is not a prerequisite to seeking relief under section 506(c), Magna's argument is otherwise disingenuous.

In this case, just after the Debtor filed its bankruptcy petition, Magna supplied additional funding to keep the Debtor's operations going (obviously not for altruistic reasons, but rather because Magna believed that doing so was in its own best interests). On September 6, 1991, just one day after the Debtor commenced its chapter 11 proceeding (and before virtually any other creditor was even aware of the case, including Hartford), Magna had its claim *allowed in full* as a secured claim as part of the interim order approving the additional financing. (*See* App. 157a ¶ 14; *see also* App. 190a-91a ¶ 14). Thus, Magna's argument that Hartford could have objected to the allowance of its secured claim cannot be taken seriously because Magna's claim was allowed long before the Debtor incurred its obligation to Hartford and also long before Hartford even became aware of the case.

The surreptitious allowance of Magna's claim is significant because it illustrates why parties such as Hartford must be permitted to pursue their own rights and interests in the bankruptcy context with respect to sections of the Bankruptcy Code that affect their interests. In this instance, Magna seeks to shift a portion of the costs of the proceedings onto Hartford's shoulders in derogation of section 506(c) by denying Hartford's right of participation to enforce the relief that the section recognizes. Because this would defeat the purpose of section 506(c), Magna ought not to prevail.

## VI. HARTFORD'S ENTITLEMENT TO PURSUE ITS CLAIM IN THIS CASE HAS COMPELLING SOURCES WITHIN THE TEXT, LOGIC, PURPOSE, AND STRUCTURE OF THE GOVERNING STATUTORY SCHEME.

Relying again on its erroneous characterization of this controversy as a private action for money damages arising between two private parties, Magna argues that Hartford lacks the ability to pursue the relief that section 506(c) recognizes under the analysis set forth in *Karahalios v. National Federation of Federal Employees*, 489 U.S. 527, 532 (1989). (*See* Magna's Brief at 46-50). Specifically, Magna quotes *Karahalios* for the proposition that

> the question of whether a party has a private cause of action under a statute "poses an issue of statutory construction . . . Unless such congressional intent can be inferred from the language of the statute, the statutory structure, or some other source, the essential implication of a private remedy simply does not exist."

(Magna's Brief at 47-48) (alteration in original).

In this instance, of course, the issue is not whether Magna may be liable to Hartford for damages under a federal statute, but how property of the Debtor's bankruptcy estate is to be distributed. Clearly Magna has no right to seize funds representing amounts that should be used to satisfy other parties' claims, and the sole issue here is whether Hartford may petition the court to enforce the governing statutory scheme where the trustee has neither the incentive nor the ability to ensure the distribution of the relevant funds to Hartford. Because proceedings under the Bankruptcy Code remain fundamentally equitable in nature, and because the function of allowing claims and distributing a debtor's estate implicates directly the court's equitable *in rem* administrative function, there can be no objection to the court's allocation of funds as the governing scheme requires on grounds that the trustee is unable or



unwilling to pursue the allocation. Because the context is distinct, reference to cases such as *Karahalios* is simply inapt.

Moreover, as this Court has recognized, different regulatory contexts may call for different methods in defining the scope of particular causes of action. *See Musick, Peeler & Garrett v. Employers Ins. of Wausau*, 508 U.S. 286, 292-93 (1993) (stating that " 'where a legal structure of private statutory rights has developed without clear indications of congressional intent,' a federal court has the limited power to define 'the contours of that structure' " (quoting *Virginia Bankshares, Inc. v. Sandberg*, 501 U.S. 1083, 1104 (1991))). More important, the Court has recognized a broader authority to define causes of action in certain areas, such as admiralty, involving "a jurisdiction in which the federal courts have had historic, well-recognized responsibility for the elaboration of legal doctrine." *Musick*, 508 U.S. at 290 (citing *Cooper Stevedoring Co. v. Fritz Kopke, Inc.*, 417 U.S. 106 (1974) and *United States v. Reliable Transfer Co.*, 421 U.S. 397, 409 (1975)).

For example, in *Cooper* the Court considered whether a defendant in an admiralty case could maintain an action for contribution against a joint tortfeasor. Acknowledging that the action could not be maintained if expressly prohibited by statute, the Court nevertheless permitted it to proceed where no such prohibition existed, concluding: "On the facts of this case, then, no countervailing considerations detract from the well-established maritime rule allowing contribution between joint tortfeasors." *Cooper Stevedoring Co. v. Fritz Kopke, Inc.*, 417 U.S. 106, 113 (1974). Similarly, in this instance, nothing in the Bankruptcy Code prohibits application of the well-established bankruptcy rule that administrative claimants have the right to recover their claims from a secured creditor's collateral in the circumstances set forth in section 506(c).

Like admiralty, bankruptcy jurisdiction defines a unique subject matter. Predominantly equitable in nature, it is also a jurisdiction in which the courts have exercised responsibility for the elaboration of doctrine. (*See* Hartford's Brief at 17).

More important, as decisions such as *Midlantic National Bank v. New Jersey Department of Environmental Protection*, 474 U.S. 494 (1986) and its progeny reveal, the Court has refined a special and specific analysis tailored to the bankruptcy context for dealing with questions precisely of the kind presented in this controversy. Hence, the Court should follow the analysis undertaken in *Midlantic* and conclude that Hartford has the right to enforce the priority of its claim under section 506(c).

Nevertheless, even assuming that reference to cases such as *Karahalios* is useful, Hartford's right to enforce the requirements of section 506(c) has many compelling sources, including the provisions and structure of the Bankruptcy Code as a whole (*see* Hartford's Brief at 28), the purpose of section 506(c) (*see id.* at 12-13), the relevant history (*see id.* at 20-25), the *in rem* nature of the proceedings (*see id.* at 33), and the overarching fact that Hartford is a party in interest whose participation is essential to ensure that the purpose of section 506(c) is vindicated. (*See id.* at 32, 40). In contrast, Magna's position rests entirely on the implausible inference that Congress's use of the term "trustee" was meant to condone in this case the very windfall that Congress sought to avoid in codifying section 506(c) in the first place. This is hardly a sound basis on which to deny an administrative claimant a right that similarly situated parties have enjoyed for over a century in the administration of bankruptcy proceedings. Hence, even under the Court's analysis set forth in *Karahalios*, unpaid administrative claimants have the right to enforce the requirements of section 506(c), and Hartford is therefore entitled to prevail in this instance.

## CONCLUSION

For the foregoing reasons, as well as the reasons set forth in Hartford's initial brief, Hartford respectfully requests that the Court determine that Hartford has the right to enforce the priority of its administrative claim under section 506(c) in this case, reverse the *en banc* decision of the Court of Appeals, and remand for further proceedings consistent with the Court's holding.

Respectfully submitted,

G. Eric Brunstad, Jr.*
Patrick J. Trostle
Renee M. Dailey
Mark W. Deveno
Helder P. Pereira
Bingham Dana LLP
One State Street
Hartford, Connecticut 06103
(860) 240-2700

Wendi Alper-Pressman
Susman, Schermer,
Rimmel & Shifrin LLC
7711 Carondelet Ave.
St. Louis, Missouri 63105
(314) 725-7300

*Attorneys for Petitioner*

* *Counsel of Record*